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Fiduciary Responsibilities for DC Plan Loans

The DOL views them as plan investments.

According to a recent article in the Tax Management Compensation Planning Journal, in any given year, 20% of plan participants have an outstanding loan from their 401(k) plan, and over a five-year period, that rises to 20%. Additionally, 10% of loans default each year, with the majority of those defaults due to job separation.

Thus, because of the prevalence of plan loans and defaults, experts say that retirement plan sponsors and their advisers need to do a better job of educating participants about the downsides of plan loans. Additionally, they recommend that sponsors offer financial wellness education that includes information about budgeting and having an emergency savings fund to potentially decrease the use of loans.

"Because the Department of Labor [DOL] views plan loans as investments, they should be treated with the same level of care and scrutiny as any other investment," says Rob Reiskytl, a partner in retirement consulting division of Aon in Minneapolis. "Plan sponsors need to consider the structure of the loans, the cost of the loans and under what circumstances they should allow these loans to be available."

James Olson, managing director at FPS Group in Centennial, Colorado, agrees that plan loans "fall into plan sponsors' fiduciary oversight. They need to establish a loan policy that considers how many loans a participant can take out and work with their recordkeeper on how to construct the loans. Loan policies are overlooked too frequently."

The 2017 PLANSONSOR Defined Contribution Survey found that 79.3% of defined contribution (DC) plans offer plan loans. Reiskytl says that figure does not surprise him, as "plan loans serve a very important purpose in that they permit participants to access their money," thereby encouraging them to participate in the plan. Without a loan provision, he says, fewer participants would be willing to sign up for the plan. "They play a very big role in making [DC plans] appealing to participants," he says.

Justin Morgan, managing director of plan administration and service at Unified Trust Company in Lexington, Kentucky, says 85% of his company's clients offer plan loans, and he agrees that "by not offering loans, you might see a drop off in participation."

Because plan loans are so prevalent, it is vital for sponsors and their advisers to monitor them carefully, Morgan says. "They need to make sure the feature is not overused, that participants not treat their [DC plan] like a line of credit, or a scenario where a participant defaults on the loan and immediately takes out another loan," he says. "Sponsors need to pay attention at the individual as well as the plan level."

Educating participants about loans

Thus, it is critical for sponsors and advisers to educate participants about the consequences of taking out loans to their retirement readiness, says Snezana Zlatar, senior vice president, head of full service product and business management at Prudential Retirement in Woodbridge, New Jersey. "Any type of a loan will have a negative impact on outcomes and retirement income," she says.

DC plan sponsors that offer loans should definitely pair them with financial wellness education that includes information

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on budgeting and creating an emergency savings fund, Zlatar adds. “Here at Prudential, we want plan sponsors to think about the broader financial wellness of the individual,” she says. “If we are thinking about financial wellness more holistically, we could encourage individuals to learn how to budget, save for emergencies and protect against risk. Financial wellness programs are very critical in helping individuals achieve financial security.”

That education should include information about the effects of a loan default, adds Dominic DeMatties, a partner with Alston & Bird in Washington, D.C. Also, a terminated participant used to have 60 days from the date of their termination to repay the loan. The Tax Cuts & Jobs Act has now extended that until their tax return due date, he adds. “It is important for people involved in administering the plans to educate participants about this,” DeMatties says.

Participants need to know that should they take out a loan, they might be likely to eliminate or reduce their deferrals to their plan, says Tom Foster, national spokesperson for workplace solutions at MassMutual in Shelton, Connecticut. “Also, some plans do not allow deferrals during the repayment period,” he says. “Think of what that does to an employee’s retirement outlook. It also eliminates the company matches, increases their taxable income and reduces the value of compounding. If you default on the loan or are laid off, then the entire balance becomes taxable, and if you are younger than 59-1/2, you will pay an additional 10% fine. The many downsides to a loan have a snowball effect. Before allowing a participant to take out a loan, sponsors should give them a tutorial on the pros and cons and require them to sign an agreement” stating that these facts were shared with them before taking out a loan.

Participants should also know that they have five years to repay the loan; 25 years if the loan is used to pay for a primary residence, says Len Hayduchok, president of Dedicated Financial Services in Hamilton, New Jersey. But should a participant leave their job or the company go out of business, the loan will be considered a distribution and the participant would need to repay the loan in full along with the taxes. In those scenarios, the loan becomes “a cascading financial problem,” he says.

Preventing loan defaults

One way plan sponsors can mitigate loan defaults, Reiskytl says, is to permit terminated participants to continue to pay off loans through Automated Clearing House (ACH) payments to recordkeepers. Only about one-quarter (26.2%) of DC plan sponsors that responded to the 2017 PLANSPONSOR Defined Contribution Survey said this feature has been or will be added to their plans. An additional 5% are considering adding the feature in the future. “I would like to see more organizations move in this direction,” says Reiskytl.

Another option available to sponsors is to make loan insurance available to participants, he adds. This is a “relatively new offering. It isn’t very common, but [insurance products] are out there and growing.”

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